Internal Revenue Service
memorandum

TL-N-1511-88
CC:TL:TS/TSANDERSON

date: FEB 29 1988

to: District Counsel, Manhattan NA:MAN
ATTN: Carmen Baerga

from: Director, Tax Litigation Division CC:TL

subject: Application of the [redacted] to the [redacted] Commodity Straddle Cases in Manhattan District Counsel

This memorandum responds to your request for technical advice of November 20, 1987, with respect to the issues below. We understand that all of your [redacted] partners' straddle cases are in suspended status.

Issues

1. Whether there is an "investment banker exception" under section 108 of the Tax Reform Act of 1984, as amended by section 1808(d) of the Tax Reform Act of 1986, that would apply to the [redacted] commodity straddle cases.

2. Whether the [redacted] would apply to any transactions found not to have occurred on an exchange or which are otherwise questionable.

3. Whether the [redacted] would apply to individual trades of the partners of [redacted] i.e., trades done by or on the account of the partners as individuals and not by or on the account of the [redacted] partnership.

Conclusions

1. There is not an investment banker exception that would apply to the [redacted] straddle cases. However, there is an exception available for straddle transactions by certain "securities trading firms"--the [redacted]--that may apply to all or some of the [redacted] straddle transactions.

2. The [redacted] results from policy concerns and litigation hazards that decrease when the bona fide nature of the transactions is questionable. Therefore, the

exception should not apply to any transactions that did not occur on a domestic exchange, or were in violation of the rules of the domestic exchange where they occurred, or to which there are any questions as to their bona fide nature.

3. The [redacted] if otherwise available, applies only to the trades executed by or on the account of the securities trading firm, here [redacted] and does not apply to the individual trading of its partners.

Discussion

Issue 1

Our office has recognized that there is a so-called [redacted] which could apply to straddle losses affected by section 108. In discussing this issue, we first need to clarify what our position is as to the source of the exception.

Section 108(a), as amended by section 1808(d) of the Tax Reform Act of 1986, allows pre-ERTA straddle losses only if "incurred in a trade or business, or . . . incurred in a transaction entered into for profit though not connected with a trade or business."[1] This follows the language of I.R.C. sections 165(c)(1) and 165(c)(2). Prior to the technical amendments of 1986, section 108(a) allowed any loss from a straddle position if the position was "part of a transaction entered into for profit." Section 108(b), also as amended, provides a per se rule that "any loss incurred by a commodities dealer [as defined in section 108(f)] shall be treated as a loss incurred in a trade or business." This dispenses with the petitioner's burden of having to prove under section 108(a) that the losses were incurred in a trade or business or in a transaction entered into for profit.[2]

The legislative history to the 1986 technical amendments provides, in part:

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[1] The for-profit standard means primarily for profit. Miller v. Commissioner, No. 85-2766 (10th Cir., Jan. 11, 1988), rev'g, 84 T.C. 827 (1985); Glass v. Commissioner, 87 T.C. 1087 (1987).

[2] As more fully explained in the memorandum attached as Exhibit A, the per se rule is available only to individuals, but may benefit partners who come within the definition of "commodities dealer," with respect to those partners' distributive share of straddle losses.

> The conference agreement follows the House bill. Under the statute as clarified by the technical correction, <u>generally a taxpayer engaged in the business of investment banking who regularly trades in commodities as a part of that business would be considered in the trade or business of trading commodities</u>. If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by the person, whether it was traded on an exchange on which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently. The conferees also wish to clarify that if an individual owns a seat on a commodities exchange, such individual will be treated as a "commodities dealer." <u>Further, if a trading firm also regularly trades commodities in connection with its business, then the commodities trading will be deemed to be part of its trade or business. The latter rule applies only to the securities trading firm itself; it does not apply to separate individual trading of its partners, principals, or employees, nor to partnerships or other organizations formed to the principal purpose of marketing tax straddles</u>.

H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-845 (1986), <u>reprinted in</u> 1986-3 C.B. vol. 4 845 (emphasis added).

It is our position that the source of the [redacted] is the "securities trading firm" language in the last two sentences of this legislative history and not the "investment banking" language. One problem with the latter is the lack of criteria in determining whether a "taxpayer" was in the "business of investment banking." [3]

We point out that the exception is independent of the per se rule under section 108(b). The exception results from policy concerns and a recognition of the litigation hazards that certain securities trading firms could prove under section 108(a) that their commodity straddle losses were incurred in a trade or business, in light of the legislative history above. Attached as

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[3] The use of the term "taxpayer" could **arguably** exclude a partnership. <u>See</u> I.R.C. section 7701(a)(14).

Exhibit A is a copy of a technical advice memorandum to your office more fully discussing the [redacted] and requirements that must be met before the exception applies. The requirements are:

(1) The transactions were bona fide in that they were not factual shams, i.e., fake or fictitious, or they were not shams in substance, i.e., prearranged solely to achieve tax-avoidance objectives;

(2) The transactions were executed on a domestic exchange within the rules of that exchange, even if the sham issue is not developed;

(3) The firm was in the trade or business of trading securities;

(4) The firm was not a syndicate as defined in I.R.C. section 1256(e)(3)(B); and

(5) The firm also regularly traded commodities in connection with its business of trading securities.[4]

As more fully discussed in Exhibit A, securities trading firm, as used in the legislative history, means an entity in the trade or business of trading securities for its own account. Certainly [redacted] was a securities trading firm, and it has apparently been assumed by most people closely involved with section 108 that [redacted] would be considered to have been a securities trading firm that regularly traded commodities in connection with its business as contemplated by the above-quoted legislative history. In fact, apparently [redacted]. Therefore, unless the information you have concerning your particular cases indicates otherwise, [redacted] should be considered to have been a securities trading firm that regularly traded commodities in connection with its business under requirements (3) and (5) above.

With respect to the fourth requirement, it is our understanding that [redacted] was not a syndicate as defined in I.R.C. section 1256(e)(3)(B). See section 108(h).[5] This would

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[4] Exhibit A sets out factors to use in determining whether the firm regularly traded commodities.

[5] Section 108(h), also as amended, generally precludes partners in a syndicate, unless they are commodities dealers, from recognizing their distributive share of losses, at least as being considered incurred in a trade or business. Based on this,

need to be confirmed, however. Furthermore, we do not know whether there are any partners who themselves may be considered to have been syndicates. Our office has not taken a position on the effect of section 108(h) on the allowability of straddle losses passed through from a nonsyndicate to a partner who itself was a syndicate. If you have any partners who were syndicates, this issue would need to be addressed.

Issue 2

It is our position that the [redacted] does not apply to transactions not done on an exchange or which are otherwise questionable. Two of the requirements set out above are that the transactions were bona fide, i.e., not factual or prearranged shams, and were executed on a domestic exchange within the rules of that exchange, even if the sham issue is not developed. These requirements mirror the prohibition on the application of the section 108(b) per se rule when the transactions were "fictitious, prearranged, or otherwise in violation of the rules of the exchange." H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 911 (1985), reprinted in 1986-3 C.B. vol. 2 911; King v. Commissioner, 87 T.C. 1213, 1219 n.8 (1986).

In this regard, we recently reviewed an issue in a refund case of a [redacted] partner [redacted] and pointed out to the Department of Justice that some of the testimony of a [redacted], an employee of the firm--[redacted]--that apparently did at least some of the commodities trading for [redacted], suggested an issue of whether the transactions were bona fide.[6] [redacted]'s testimony of [redacted], taken by the Service during the audit of [redacted], included testimony that [redacted] used the after-hours session for [redacted] trades and suggested that [redacted] did not use the prices at the closing of the day's trading session, i.e., exchange-day "settlement prices." The issue suggested by this testimony is whether the transactions, to which [redacted]'s testimony relates, were prearranged solely (as opposed to only incidentally or even primarily) for tax-avoidance

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it is our position that the exception should also not apply with respect to syndicates.

[6] This was in review of a letter sent from your office, and we have enclosed a copy of the revised letter (Exhibit B) and your legal file which contains excerpts of [redacted]'s testimony.

purposes, to be determined in a manner consistent with the analysis used in DeMartino v. Commissioner, T.C. Memo. 1986-263, modified, 89 T.C. 583 (1987).

In DeMartino the Court found that the transactions, actually executed on an exchange but in violation of the rules of that exchange, were prearranged shams. See also Glass v. Commissioner, 87 T.C. 1087 (1986) (while the transactions in Glass were more abusive than those in DeMartino, the Court used a prearranged sham analysis in finding that the transactions were not bona fide, while assuming, but not deciding, that the transactions were not factual shams [7]).

We cannot be sure at this time of the import of [redacted]s testimony with respect to your cases. It could very well be, as argued by the representative in the [redacted] case, that the exchange rules allowed for the trades to be conducted in this manner, as was the case in Smith v. Commissioner, 78 T.C. 350 (1982). If so, the trades could be deemed to have occurred on the exchange, within the rules. Even in this event, however, as more fully discussed below, such trading practices present an issue concerning the measurement of the losses.

In any event, if the petitioners cannot convince you that the transactions were completely bona fide, the exception should not apply to those transactions. As we have pointed out, the exception results from policy concerns and a recognition of litigation hazards that certain securities trading firms should be given deference by the government, and could be given deference by the courts, pursuant to the legislative history above. This is true even though the petitioners might not could prove that the straddle transactions were an integral part of the firm's trade or business. If the transactions are questionable as to their bona fide nature, these concerns and hazards decrease. In this regard, any transactions to which [redacted]s testimony may relate may be sufficiently questionable as to their bona fide nature not to warrant full concession of those particular losses, even if the transactions were technically done within the rules of the exchange. If done in violation of the rules, the exception clearly would not apply.

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[7] We cannot conclude as to whether or not there are any transactions in question to which there would be an issue of factual sham. See, e.g., Freytag v. Commissioner, 89 T.C. No. 60 (October 21, 1987); Price v. Commissioner, 88 T.C. 860 (1987); Brown v. Commissioner, 85 T.C. 968 (1985); Forseth v. Commissioner, 85 T.C. 127 (1985). See also Glass, supra (it is still our contention that the transactions in Glass were also factual shams).

If you have transactions that were clearly executed off an exchange or on a foreign exchange, it is our position that the exception does not apply even without inquiring as to their bona fide nature. This position is similar to the position we have taken with respect to the section 108(b) per se rule and results from the abusive nature of most of these types of transactions.

We point out that, even if the exception is not available, the cases may be settled under the Administrative Disposition of Commodity Cases (memorandum dated February 24, 1987). The commodity initiative generally has two settlement positions for nondealers.[8] The positions are based on whether the transactions were on or off the market. For these purposes, transactions that were done on an exchange but in violation of the rules of that exchange should be treated as off-the-market transactions. Furthermore, if the sham argument is or can be developed, the particular transactions to which the sham argument relates should not be settled under the initiative.

As a final note under this issue, we took the position in the letter to the Department of Justice that [redacted]'s testimony that [redacted] used the after-hours session for [redacted] trades and suggesting that exchange-day settlement prices were not used indicated that there was an issue as to the correct bases and amounts realized to be used in the measurement of the amount of straddle losses. This issue was discussed in Smith v. Commissioner, supra,. The Court essentially held that in such instances the bases should be equal to the settlement prices on the day the legs were acquired and the amounts realized should be equal to the settlement prices on the day of disposition of the legs.

In this regard, the representative in the [redacted] case argued that section 108 overruled this part of the Smith opinion and that the losses should be allowed as reported. Section 108 does not deal with measurement of straddle losses, only the allowability; it did not affect this portion of Smith. In fact, no part of the opinion was affected by section 108. Miller, supra; Glass, supra.

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[8] Dealer in this context is limited to those individuals meeting the definition of "commodities dealer" under section 108(f), as amended. Any argument that [redacted] was a dealer in commodities should be treated essentially as an argument that the [redacted] applies unless it could be proven that [redacted] was indeed a "dealer" in commodities or was in the "trade or business" of trading commodities per se as those terms are understood under general tax principles.

Issue 3

The legislative history quoted above is authority for the proposition that the [redacted], if otherwise available, would apply only to the trades executed by or on the account of [redacted] and not to the individual trading of its partners:

> Further, if a trading firm also regularly trades commodities in connection with its business, then the commodities trading will be deemed to be part of its trade or business. The latter rule applies only to the securities trading firm itself; it does not apply to separate individual trading of its partners, principals, or employees, nor to partnerships or other organizations formed for the purpose of marketing tax straddles.

H.R. Conf. Rep. No. 99-841, supra (emphasis added).

The losses from the individual trading may, however, be subject to settlement under the commodity initiative.

If you have any questions or need any further assistance, please contact Ted Sanderson on (FTS) 566-3233.

MARLENE GROSS

By: Kathleen E. Whatley
KATHLEEN E. WHATLEY
Chief, Tax Shelter Branch

Attachments:
As stated.